



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

Release Number: **201007063**

Release Date: 2/19/10

Date: November 25, 2009

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Contact Person:

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Identification Number:

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SE:T:EO:RA:T:3

Employer Identification Number: XXXXXXXXX

Dear

This is in response to your request for a ruling that certain proposed contractual relationships will not generate unrelated business taxable income under section 512(a)(1) of the Internal Revenue Code (the "Code").

You are exempt under section 501(a) of the Code as an organization described in section 501(c)(3) and have been classified as a publicly supported organization described in sections 509(a)(1) and 170(b)(1)(A)(iv). You were formed to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a University, an organization described in section 501(c)(3) and classified as a publicly supported organization described in sections 509(a)(1) and 170(b)(1)(A)(ii).

You solicit and receive donations on the University's behalf. Although some donors make unrestricted donations for the general benefit of the University, most donors request that their contributions benefit a particular program, department, school, or campus of the University. You categorize these restricted gifts in accounts that you track according to the University program, department, school, or campus to be benefited (the "Accounts"). The funds in the Accounts are pooled for investment purposes in a general long term fund (the "Pooled Fund").

The Pooled Fund is invested in a diverse manner, including but not necessarily limited to substantial investments in domestic and international public and private equities, domestic and international bonds and other fixed income assets, and real estate. Much of the income earned consists of passive dividends, interest, and there may also be long and short-term capital gains. Some income may be debt-financed or otherwise treated as unrelated business taxable income.

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You use a "unit" concept internally to administer the Accounts within your Pooled Fund. Each Account is allocated a certain number of units of the Pooled Fund, the value of which is based on a proportionate value of the underlying Pooled Fund investments. You determine a payout rate on units each year based in part on the Pooled Fund's investment performance. Distributions are determined by a spending policy, the algorithm of which is established by the investment policy approved and periodically reviewed by your Board of Directors. Each Account is entitled to distribution based on the number of units it holds and the applicable payout rate. You calculate the value of the Pooled Fund units on a monthly basis, and units may be redeemed for that value. In order to offset direct administrative and other costs incurred in raising, investing, managing, and tracking the Accounts in the overall Pooled Fund, you assess an administrative fee on the market value of each Account within the Pooled Fund, assessed on a monthly basis. The Pooled Fund also incurs expenses in connection with fund management services provided by third-party managers. You pay those expenses to third-party managers directly from the Pooled Fund.

In addition to holding and managing the Accounts, you are the trustee of a number of charitable remainder trusts (the "Trusts") that were established for the benefit of you and/or the University. As trustee, you are the legal owner of the Trusts' assets. Each Trust has you and/or the University as its sole remainder beneficiary or beneficiaries. As a result of its relationship with the Trusts as both trustee and beneficiary (or, in some cases, the fundraising vehicle for the sole beneficiary, the University), you have a substantial interest in the value of the Trusts. Moreover, the donors to the Trusts in each case intended that you and the University benefit substantially from the assets of the Trusts, and that the assets would be managed to achieve the greatest possible return on investment. Accordingly, you seek to enable the Trusts to participate, albeit indirectly, in the return on your Pooled Fund, as described below. Unlike your practice with respect to the Accounts within your Pooled Fund, you will not assess the administrative fee, described above, against Trust assets held in the Pooled Fund. You will continue to assess fees as trustee with respect to the administering the Trusts.

You seek to enable the Trusts to invest in the Pooled Fund in a manner similar to the Accounts and thereby to receive an investment return roughly equal to that of the Pooled Fund. Specifically, you will issue a contract right for units in the Pooled Fund to each of the Trusts. The value of the contract units would be based on the value of all the underlying investment assets held by the Pooled Fund and would have the same unit value that you use for internal accounting purposes with respect to the Accounts. The contracts between you and the Trusts would provide that the price of the units would equal their value at the time of acquisition. The contracts further would provide that each Trust would receive payments on the units held by it based on the payout rate you establish for the Pooled Fund and the number of units held, with payouts made at least annually or more frequently as appropriate. A Trust could choose either to reinvest part of the payout, or redeem additional units, depending on its cash requirements. The Trusts would treat payouts as ordinary income, regardless of the character of the underlying income of the Pooled Fund, whether capital gain, ordinary income, or return of capital. The Trusts would treat redemptions of the units (over and above receipt of the spending rate) as generating long or short-term capital gain (or loss), depending on the holding period of the redeemed contract units.

Under each contract, a Trust would not have any ownership interest in the underlying assets of the Pooled Fund or any contract rights with respect to the other Trusts. The trusts would have

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no power or right of any kind to control, direct, supervise, recommend, or review your business activities, operation, or decisions with respect to the Pooled Fund, except the right to review the payout computations. The Trusts would not have the right to veto or opt out of any of the underlying Pooled Fund investments. Each contract would provide that, with respect to the issuance of contract units, you are neither a partner nor an agent of the Trusts; that the Trusts would never be or become liable for any cost, expense, or payment incurred or due by you or for which you are liable or responsible relating to the Pooled Fund (or the underlying Pooled Fund assets); and, consistent with your status as a fiduciary, you will not allow the Trusts to suffer any liability arising out of any action or inaction by you with respect to the Pooled Fund (or the underlying Pooled Fund assets).

You have requested the following ruling:

The issuance of units by you to the Trusts, the making or receipt of payments with respect to the units, and the holding or redemption of units will not generate unrelated business taxable income to you.

#### LAW

Section 501(c)(3) of the Code, in part, provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable, educational, scientific, and certain other purposes.

Section 511 of the Code, in part, imposes a tax on the unrelated business taxable income of organizations described in section 501(c)(3).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in section 512(b).

Section 512(b) of the Code sets forth so-called "modifications," which are excluded from the computation of unrelated business taxable income. These modifications include dividends, interest, royalties, rent from real property, and gain from the sale of property.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt purpose or function.

Section 513(c) of the Code provides that the term "trade or business" includes any activity, which is carried on for the production of income from the sale of goods or the performance of services.

Section 1.513-1(a) of the Income Tax Regulations provides that gross income of an exempt organization subject to the tax imposed by section 511 of the Code is includible in the computation of unrelated business taxable income if: (1) it is income from a trade or business;

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(2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(b) of the regulations provides that for purposes of section 513 of the Code the term "trade or business" has the same meaning it has in section 162 and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(c)(1) of the regulations provides that in determining whether trade or business from which a particular amount of gross income derives is "regularly carried on," within the meaning of section 512 of the Code, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. For example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of non-exempt organizations.

Section 1.513-1(d)(1) of the regulations provides that, in general, gross income derives from "unrelated trade or business," within the meaning of section 513(a) of the Code, if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question -- the activities, that is, of producing or distributing the goods or performing the services involved -- and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes, and is "substantially related," for purposes of section 513 of the Code, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Rev. Rul. 69-528, 1969-2 C.B. 127, describes an organization that was formed to provide investment services on a fee basis exclusively to organizations exempt under section 501(c)(3) of the Code. It receives funds from the participating exempt organizations, invests in common stocks, reinvests income and realized appreciation, and upon request liquidates a participant's interest and distributes the proceeds to the participant. The Rev. Rul. states that providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for profit. If the services were regularly provided by one tax-exempt organization for other

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tax-exempt organizations, such activity would constitute unrelated trade or business. The Rev. Rul. holds that the organization is not exempt under section 501(c)(3)

As noted previously, organizations described in section 501(c)(3) of the Code are subject to tax on their unrelated business income under section 511. In order for such an organization's income to be subject to the unrelated business income tax, three requirements must be met: (1) the income must be from a trade or business; (2) the trade or business must be regularly carried on; and (3) the conduct of the trade or business must not be substantially related to the organization's exempt purpose or function. See section 1.513-1(a) of the regulations.

## ANALYSIS

You propose to enter into a contractual relationship with certain Trusts that are charitable remainder trusts in which you have an interest as a beneficiary and serve as trustee. Under such a contractual relationship, each Trust would receive payments on the units held by it equal to the payout rate you establish for your Pooled Fund, with payouts made as determined by you.

Each Trust would acquire units from your Pooled Fund, which would give the Trusts a contractual right against you, but no interest whatsoever in the underlying investment assets of the Pooled Fund. The contract between you and the Trusts would provide that the price of the units would equal their value at the time of acquisition. The units would have the same value that you use for internal accounting purposes.

Consequently, a Trust could choose either to reinvest part of the payout, or redeem a portion of the units, depending on its cash requirements. Thus, under the contractual relationship with you, the Trusts would have a right to the payout declared by you plus the right to redeem the units at the value that you use for internal accounting purposes.

Generally, an organization that otherwise qualifies for recognition of exemption under section 501(c)(3) of the Code and provides investment services on a regular basis for a fee to other exempt or nonexempt organizations would be engaged in an unrelated trade or business under section 513(a). See Rev. Rul. 69-528, supra. Such an activity would constitute a "trade or business" under sections 513(c) and 1.513-1(b) of the regulations, and would be "regularly carried on" under sections 512(a)(1) and 1.513-1(c). Thus, if you charged a fee for investment management services provided to organizations unrelated to you or generated income from the management of the funds invested by such organizations, these activities could result in unrelated business taxable income under section 512(a)(1). Here, however, you are not charging a fee for services and not otherwise receiving income from the services provided to the Trusts. Thus, under these circumstances, you will not receive unrelated business taxable income under section 512(a)(1).

The fact that you will engage in the investment activity for the benefit of individuals who are co-beneficiaries of the Trusts at the same time that you engage in investment activity for your own benefit as the remainder beneficiary limits the scope of the service provided to "others" and distinguishes it from a commercial venture.

In view of the foregoing, we rule as follows:



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The issuance of units from you to the Trusts, the making or receipt of payments with respect to the units, and the holding or redemption of the units, will not generate unrelated business taxable income to you.

This ruling is based on the following two assumptions:

1. You will not charge any fee for managing the investment of the Trusts in your endowment. Other third party management firms charge a fee and receive reimbursement of expenses for management services provided to your endowment. These fees and expenses are charged against the aggregate return of the endowment and will be reflected indirectly in the payout to the Trusts and others participating in the endowment. You will continue to be entitled to the fees any trustee may receive with respect to the administering the Trusts.
2. You are the sole charitable beneficiary of each charitable remainder trust.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based.

We express no opinion as to the tax consequences of the proposed transaction under any other section of the Code.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to your authorized representatives. A copy of this letter should be kept in your permanent records.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

If there are any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Manager, Exempt Organizations  
Technical Group 3

Enclosure  
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